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MULTINATIONAL CORPORATIONS

VOLUME 2

MULTINATIONAL TAX

IAN F. G. BAXTER

JANUARY, 1984

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Multinational Corporations Seminar

Part I: Notes Reference Multinational Taxation

Introduction

The purpose of the tax section of the Seminar on Multinational Corporations is to introduce students, generally, to a consideration of tax problems and strategies that may be relevant if a corporation in country X conducts operations in other countries through business entities or establishments in these countries. This approach to taxation is sometimes labelled conveniently "multinational taxation". By definition the topic involves consideration of the tax laws of more than one country and the basic elements are: (i) comparative study of national systems of taxation affecting international business operations (e.g. income taxation of business entities); (ii) bilateral tax agreements between countries (which provide some relief from "double taxation" of the same income by different countries). Nowadays most such agreements are based on a model agreement prepared by the Organization for Economic Co-operation and Development (O.E.C.D.). Multinational taxation is an important factor in determining the profitability of the business operations of multinationals, and charges on repatriation of profits. There are substantial differences between the rules and rates of relevant taxes in different countries (e.g. rates of corporation income tax range from zero to over 50%). It is also an important element in tax planning by governments.

The study of "multinational taxation" is, therefore, more general and to be distinguished from a study limited to the Canadian tax rules which affect (i) foreign business operating in Canada, and (ii) taxation of the foreign income of Canadian corporations. The Seminar on Multinationals does not aim to provide a detailed study concentrated on the sections of the Canadian Income Tax Act affecting the taxation of foreign business in Canada and the foreign income of Canadian corporations. Multinational taxation, instead, looks at revenue laws comparatively from the points of view of multinationals with widely-based business operations in many countries, and host governments.

The contents of these Notes are:

(a) Introduction.

(b) Summaries of the main income tax provisions affecting international business operations in the following countries: Canada, France, West Germany, Hong-Kong, Japan, Netherlands, Switzerland, U.K., U.S.A., and Venezuela.

(c) Brief comments on comparative indirect taxation, particularly Value Added Taxes in the European Common Market.

In regard to (b), the country-by-country summaries are each arranged with a similar format (to facilitate cross-comparison). This format generally includes:

(1) Taxation of Business Entities This indicates the main income taxes affecting business; business entities (e.g. corporation, partnership, branch) and the kinds of taxes for which they are liable;

the jurisdictional range of corporation taxes (e.g. whether a tax is levied on: world-wide income, only on national source income, on income connected with business, operations, etc.); rates of tax; capital gains taxes.

(2) Taxation of Foreign Investments. This involves consideration of taxation of income received from another country. Such income may already have suffered foreign taxes, e.g. foreign withholding tax, foreign corporation income tax. Foreign income may be only taxable in the foreign source-country (e.g. by virtue of a double-taxation treaty) or it may be taxable in both the source-country and the recipient-country (e.g. if corporation tax of the recipient-country is not limited to national source income). If it is taxable in both, then (by virtue of a double-taxation treaty, or often unilaterally if there is no applicable treaty) there will usually be a measure of relief in the form of a tax credit for certain of the foreign taxes, and the nature of this credit, and limitations on the amount of the credit are mentioned. The credit may be more extensive in the case of a certain degree of association between the foreign-source and domestic-recipient business entities, and this is mentioned.

(3) Taxation of Shareholders

Dividends to shareholders are usually paid out of profits that have already suffered domestic corporation tax, and they are also taxable income of the recipient shareholders. This may be regarded as a type of (domestic) "double-taxation". Many countries grant some relief from this, e.g. in the form of crediting back to the shareholder some of the corporation tax related to the dividend. But the policies

and approaches are different in different countries. [Some general comment on this topic, particularly related to "harmonization" of tax laws in the European Common Market, is made later in this Introduction].

(4) Foreign Undistributed Income

A domestic corporation establishes a foreign-base company in a foreign country which is a "tax haven" (having low corporation tax or none at all). The foreign base company is merely a low-tax collecting point for revenue from activities such as: asset holding, leasing, provision of management services, processing bank loans and insurance business. The foreign-base company does not repatriate the income received but accumulates it (and perhaps lends it to other units of the multinational). Some western countries consider that such foreign undistributed income should not escape domestic taxation and they have anti-avoidance legislation with this in view.

(5) Corporate Groups and Reorganizations

Some forms of acquisition or reorganization change the economic position of the corporations or their shareholders and are taxable transactions, while others may not change the economic position of the corporations or their shareholders and may be tax free.

(6) Tax Incentives

Many countries have special tax incentives as part of their economic policy. Some of these are indicated in the Notes.

Students in the Seminar on Multinationals are required to attend class sessions and to write a research paper. So while students A and B both attend the 3 or 4 two-hour class sessions on multinational tax, student A may be doing a research paper on multinational tax but student B may be doing a research paper on some other area of the Seminar (e.g. the relation of multinationals and host and parent countries).

The purpose of the Notes is to provide background reading

material for both students A and B, and also the Notes are more detailed than might otherwise be required for this purpose, in order to give A some general "start-up" material to assist in thinking about the research paper.

Obviously, the country-by-country summaries are substantially limited both as to completeness of coverage and detail. Some important topics for the tax practitioner have been omitted because they could not be properly treated without overloading this Note with masses of detail. An example is the question of property in respect of which certain deductions are allowed against taxable income because the property depreciates in value with time. Different countries have different approaches to this question, and most have complicated rules, and rates for different types of property. No easy general comparison can be made between one country and another in regard to depreciation allowances without becoming involved in attempted rate comparisons between similar classes of property, and so on. But allowances related to depreciation, and other forms of tax allowances related to assets, are of practical importance in given cases and can involve substantial sums of money.

Another large and complicated subject that it is not possible to deal with in detail in notes such as these, is the general area of transactions between head offices of multinationals and their foreign-situs subsidiaries and branches. This includes what is known as "transfer pricing". Suppose the head-office of multinational X situated in country A provides management services to its subsidiary

in country B, charging a price P for the service. An increase in P will increase the taxable income of the head-office and decrease the taxable income of the subsidiary (by increasing its costs) and a decrease in P will have the reverse effect. If the business taxes levied in A differ substantially from those in B, variations in P could change the total tax burden of the parent and subsidiary. Applying this to a large multinational with operations in many parts of the world, there would be significant possibilities for reducing the total (world) taxes paid by the multinational. Tax is not the only consideration involved in transfer pricing, but it is an important one.

Most governments are under pressure to collect as much tax revenue as possible to help to meet their heavy expenditures and to reduce borrowing. So many governments now adopt a tougher attitude than in the past to prevent loss of revenue by the adjustment of transfer prices. The main weapon against international tax avoidance by transfer pricing is the principle of "arm's length bargaining" i.e. prices charged between associated enterprises should not differ from those which would have been negotiated between fully independent enterprises. The principle appears, directly or indirectly, in many national laws and in double-taxation treaties. For example, article 9 of the OECD Model Convention reads:

"Where (a) an enterprise of a Contracting State participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting State, or (b) the same persons

participate directly or indirectly in the management, control or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State, and in either case conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly."

Although the concept of an "arm's length" price may seem to be a neat formula in theory, it presents difficulties in practice because normal open market conditions often do not exist. Among the methods used to apply the formula are: (i) prices charged to foreign customers are compared with prices charged to domestic customers; (ii) prices charged to foreign customers are compared with prices charged by other enterprises; (iii) production costs plus a net profit margin; (iv) sales minus a net profit margin; (v) average gross profit of the type of business applied to production cost.

It can be a difficult task for a multinational with operations in many countries to adjust its pricing strategies to correspond with many different national interpretations and applications of arm's length transactions. In 1976, in the European Common Market, a proposed directive was submitted to the EEC Council for arbitration procedure which would apply to transfer pricing disputes. The proposal was that if "the tax administrations of the countries

involved in a price adjustment procedure cannot agree on an arm's length price to be used in the pertinent case, the matter in dispute would be referred to an arbitration commission which will make a decision which is binding as to all parties, thus definitively preventing economic double taxation": (van Waardenburg, Transfer Pricing Arbitration Procedure, 18 European Taxation, 144-151 at 146; the text of the proposed directive is reproduced at pp. 149-151). Unfortunately the directive has not yet been adopted.

One of the topics mentioned above (under "Taxation of Shareholders") is the question of a companies' profits being subject to corporation tax before payment of a dividend and then the dividend also being subject to tax (as income of the shareholder). Some countries provide relief from this so-called double-taxation of dividends in different ways (e.g. by "imputing" or crediting the shareholder with some of the corporation tax paid by the company that distributes the dividend) and some not at all. Variations in approach to this problem can make significant differences to the total amount of income received from the company (i.e. the cash dividend plus any tax credit) and so can increase or decrease the attractiveness of equity investment in a particular country. The following are examples of present-day approaches to this problem and differences in principle.

(a) "Classical" system. Under this system, the revenue authorities collect both corporation tax (at full rate) from the company paying the dividend, and tax from the shareholder on the dividend received. No tax credit is given. In other words, the "double-

taxation" issue is ignored. This was the position in most countries up to a decade or so ago.

(b) "Two-rate" system. This is the system in West Germany. Distributed profits are taxed at a lower rate of corporation tax than undistributed profits. The shareholder then receives a tax credit (in West Germany this is equal to the reduced rate of corporation tax). The amount of the credit is taxable income of the shareholder.

Let C = the reduced rate of corporation tax; T = the effective rate of tax of the shareholder; and S = the sum to be distributed by the company (before deduction of corporation tax). Then the dividend received by the shareholder is S - CS. The taxable income of the shareholder (related to the dividend) equals the dividend received plus the tax credit. Let the tax credit = C (as in West Germany). Then the taxable income related to the dividend = S, and the tax payable by the shareholder is TS - C. Consequently, the total amount of tax obtained by the government from (i) the shareholder and (ii) the shareholder is: (TS - C) + C = TS. This means that the total tax obtained equals tax at the shareholder's effective rate on the sum distributed by the company, and this total is collected partly from the company and partly from the shareholder.

(c) "Advance corporation tax" (A.C.T.) system. This is the system in the United Kingdom. A company issuing a dividend, pays an instalment of corporation tax, i.e. A.C.T. A shareholder receives a tax credit equal to the amount of ACT appropriate to the dividend. The amount of the credit is taxable income of the shareholder.

In current U.K. tax law, this system is set up so that an individual taxpayer with a certain personal income tax rate (called the "basic" rate: which was 33% in 1978/79) pays zero personal income tax on the dividend.

(d) "Avoir fiscal" system. This is the system in France.

A tax credit (called an "avoir fiscal") is given, amounting to half the dividend received. The avoir fiscal is taxable income of the shareholder.

In regard to the taxation of dividends, different imputation systems can be distinguished according to whether or not they ensure that the individual shareholder does not claim a dividend credit or abatement in respect of dividends from a domestic corporation paid out of income which has not borne the appropriate rate of corporate tax. Of the industrialized countries, the Canadian and Italian systems involve an "automatic" dividend tax credit unrelated to the corporate income tax.

[For an algebraic comparison of the effects of different approaches to dividend taxation see "The Structure and Reform of Direct Taxation" (1978): the "Meade Report", pp. 265-268].

The creation of a Common Market was the object of the Treaty of Rome (1958) which established the European Economic Community (E.E.C.). The tax provisions of the treaty relate to the basic aims of the E.E.C., namely, free movement of goods, persons, services, and capital. So far as taxation is relevant to these aims, it is the concern of the Community to "harmonize" the tax laws of the constitute countries.

Certain articles of the Treaty of Rome apply to taxation. Article 95 prevents higher duties being levied on goods imported from other EEC countries than are correspondingly levied on domestic goods, and articles 95

and 96 together are intended to prevent revenue discrimination against imported goods in favour of domestic goods. Generally (in articles 95-99) the purpose is to harmonize national legislation on turnover taxes, excise duties, and other forms of indirect taxation. One result has been the introduction of a value-added tax (V.A.T.) based on the same general principles throughout the EEC. [See the discussion of this type of tax in the last part of these Notes].

The Commission of the EEC has also considered the question of harmonization of systems of company taxation and of withholding tax on dividends. [Details and discussion of the Commission's proposals are given in 16 European Taxation, nos. 2-4 and 18 European Taxation, pp. 372-383 See also Soldati, Taxing Corporate Income (1976) 24 Amer. J. of Comp. L., 246.

The bases of the Commission's proposals are that (1) each Member State will apply a single rate of corporation tax which must lie between 45% and 55%, and (2) a dividend by a corporation of a Member State will confer a right to a tax credit on a shareholder who is a resident in a Member State. There will be only one rate of tax credit in each Member State which must lie between 45% and 55%. Consequently, the "harmonization" proposal by the EEC Commission for the taxation of dividends resembles (on the average) the "avoir fiscal" system which pertains in France. [See supra this Introduction and the notes on France].